

Internal Revenue Service
memorandum

CC:FS:TL-N-9557-91
CORP:LEGardner

date: NOV 8 1991

to: Regional Counsel CC:NA
Attn: Anne Hintermeister, Special Trial Attorney, NAR
Carmen M. Baerga, Attorney

from: Assistant Chief Counsel (Field Service) CC:FS

subject: [REDACTED]
[REDACTED]

On August 13, 1991, this branch received a request for Field Service Advice from your office with respect to the above case. Your office indicated that [REDACTED] ordered the parties to file trial memoranda setting forth the issues and their respective positions on or before [REDACTED]. We responded to your request for Field Service Advice verbally on August 14, 1991, and recommended that you do not assert the tax benefit contention with respect to the issues in this case. Your office told us that you have notified the court that you will not assert the tax benefit rule contention with respect to the issues in this case. We are following up with this written response as per your request.

ISSUES

1. Whether [REDACTED] should be charged with tax benefit recapture income on its section 338 deemed sale return on account of its deemed sale of its news film library.

2. Whether [REDACTED] should be charged with tax benefit recapture income on its section 338 deemed sale return on account of its deemed sale of its employment contracts.

RECOMMENDATION

We recommend that you not advance the argument that [REDACTED] be charged with tax benefit recapture income on its deemed sale return for [REDACTED] on account of its deemed sale of the news film library and employment contracts.

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FACTS

██████████ (hereinafter ██████) was engaged in television broadcasting and other activities not relevant here during the years in issue, ██████ and ██████. ██████ owns and operates ██████ network affiliated television stations. ██████ (hereinafter ██████) owned and operated television stations in ██████ and ██████.

On ██████, ██████ entered into a Stock Purchase Agreement to acquire all of the stock of ██████ from ██████. The stock purchase closed on ██████. Pursuant to the purchase agreement, ██████ elected under section 338(g) to apply the general rule of section 338(a) and treat the acquisition as a deemed sale and purchase of the assets of ██████. A one-day return was filed for the target corporation reporting the tax consequences of the deemed sale.

██████████'s assets included a news film library and employment contracts. The library consists of stock footage from news reports which have aired on past news, and local and sporting events programs. Some of this footage has historical value and some is generic background footage that can be reused. Your office told us that you do not have any information concerning the actual expenses involved in the creation of the library and that it was unlikely that the taxpayer would provide that information. However, you determined that the salaries of the personnel who created the library and the depreciation claimed with respect to equipment used in the library also contributed to the income earned by the stations in the years in which the salaries and depreciation were claimed as deductions. The library was not treated as an asset on ██████'s financial statement prior to the acquisition.

██████████ maintained employment contracts with key on-air personnel to ensure their continued service. The ██████ stations had ██████ employment contracts. ██████ currently deducted the costs of recruiting, hiring, training, and promoting the employees on its pre-acquisition tax returns. The employment contracts were not treated as assets on ██████'s financial statements prior to the acquisition.

Following the acquisition, ██████ continued its operations as a subsidiary of ██████ and filed consolidated returns with ██████ for the taxable years ██████ and ██████. On these returns, ██████ claimed amortization deductions with respect to the library and employment contracts. On the one-day return, the fair market value of the library and employment contracts, as of the date of acquisition, was reported as \$██████████ and \$██████████, respectively.

In the notice of deficiency, the Service determined that, as a result of the deemed sale of the library and the employment contracts, [REDACTED] had tax benefit recapture income in the amounts of \$[REDACTED] and \$[REDACTED], respectively. The Service allowed the amortization deductions claimed with respect to the library. The amortization for the employment contracts was disallowed on the grounds that these items are inseparable from goodwill and going concern.

DISCUSSION

The following discussion will apply to both issues. Strict adherence to an annual accounting system creates transactional inequities and distorts income. The tax benefit rule originated as a judicially developed principle that allays some of the inflexibilities of the annual accounting system. The tax benefit rule must be applied on a case-by-case basis, and the court must consider the facts and circumstances of each case in light of the purpose and function of the provisions granting the deductions.

The tax benefit rule was traditionally applied where the taxpayer made an actual recovery of an amount previously deducted. The Supreme Court in United States v. Bliss Dairy, Inc., 460 U.S. 370, 383 (1983), extended the application of the tax benefit rule not only to tax recoveries but also to approximate the results produced by a tax system based on transactional rather than annual accounting.

In Bliss Dairy, the taxpayer, Bliss Dairy, Inc., was engaged in the business of operating a dairy. The taxpayer purchased cattle feed for use in its business and deducted the full cost of cattle feed upon purchase of the feed pursuant to section 162(a). Upon liquidation, the taxpayer, distributed its assets, including unused cattle feed, to its shareholders. The shareholders continued to operate the dairy business and allocated basis to the assets pursuant to section 334(c). The shareholders, subsequently, deducted their basis in the cattle feed as an expense of doing business under section 162(a).

The Service determined that the tax benefit rule applied to recapture the earlier deductions. The Court concluded that "the tax benefit rule will apply when a later event is "fundamentally inconsistent with the premise on which the deduction was initially based." United States v. Bliss Dairy, Inc., 460 U.S. at 383-384. The Court noted that section 162(a) permits a deduction for the "ordinary and necessary expenses" of carrying on a trade or business and that such deduction is predicated on the consumption of the asset in the trade or business. United States v. Bliss Dairy, Inc., 460 U.S. at 395. The Court noted that the distribution of the unused cattle feed to the shareholders in liquidation was a nonbusiness use of the cattle feed. The Court held that the liquidation was fundamentally

inconsistent with the earlier deduction and, therefore, the tax benefit rule was applicable to require the inclusion in income of the amount of the unwarranted deduction. United States v. Bliss Dairy, Inc., 460 U.S. at 395.

Other cases addressed the issue in Bliss Dairy. These cases involved similar factual patterns in which a corporation claimed deductions under section 162 for expenses directly related to an asset. Upon liquidation of the corporation, the asset was distributed to its shareholders. The courts concluded that the distribution of the unconsumed asset was a conversion of the asset to a nonbusiness use which was fundamentally inconsistent with the allowance of the deduction under section 162 and, therefore, the tax benefit rule applied to recapture the deduction. See Tennessee Carolina Transportation, Inc. v. Commissioner, 65 T.C. 440 (1975), aff'd, 582 F.2d 378 (6th Cir. 1978), cert. denied, 440 U.S. 909 (1979); Spitalny v. United States, 430 F.2d 195 (9th Cir. 1970); Byrd, Transferee v. Commissioner, 87 T.C. 830 (1986), aff'd, 829 F.2d 1119 (4th Cir. 1987); Ballou Construction Co. v. United States, 611 F. Supp. 375 (D. Kan. 1985).

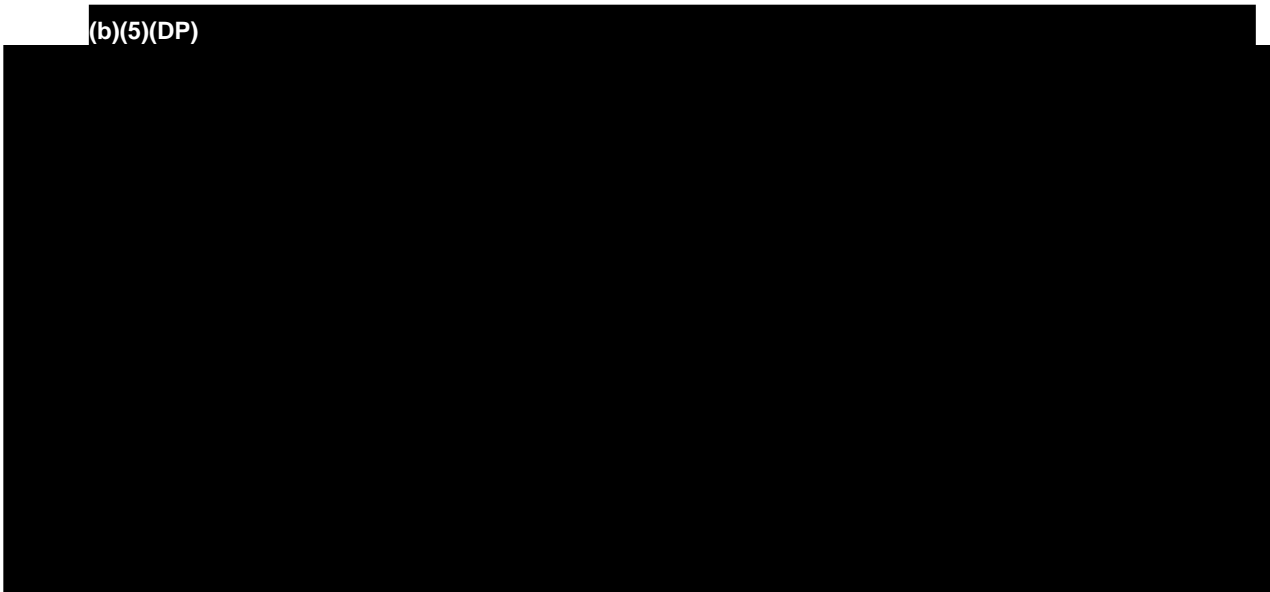
More recently, the Tax Court resolved this issue in favor of the taxpayer. In Rojas v. Commissioner, 90 T.C. 1090 (1988), aff'd, 901 F.2d 810 (9th Cir. 1990), Schwartz Farms, Inc., was engaged in the business of the cultivation of crops. Schwartz Farms, Inc., deducted the cost of seed, fertilizer, water, labor, equipment rent and maintenance, pesticide, supervision, and general administrative overhead under section 162 in the year the costs were incurred. Before the crops were sold, and before some of the crops were even harvested, the corporation adopted a plan of complete liquidation under section 337 and distributed the crops to its shareholders. The shareholders continued to operate the farm and subsequently sold the crops in the ordinary course of the farming business. In Rojas, no gain was recognized by the corporation on the distribution of the crops, under section 336(a), and the shareholders took a basis in the crops equal to its fair market value under section 334(a).

The taxpayer did not challenge the conclusion that a liquidating distribution of an asset is a conversion of that asset to a nonbusiness use. The Service argued that a deduction under section 162 presumes that an expense is necessary to produce income and that if no income results due to an intervening personal use of the asset, then there is a fundamental inconsistency which requires application of the tax benefit rule. Rojas v. Commissioner, 90 T.C. at 1101. The Service argued that the deductions under section 162 were predicated on the sale of the product produced and not just consumption of the materials and services to produce the crops. Rojas v. Commissioner, 90 T.C. at 1101. The court disagreed with the Service stating that the position of the Service would expand


the tax benefit rule beyond its intended scope. Rojas v. Commissioner, 90 T.C. at 1103. The court concluded that the liquidation was not fundamentally inconsistent with the deduction under section 162 because the materials and services upon which the deductions were based were actually consumed or used up in the cultivation of the crops and were not converted to a nonbusiness use and, thus, the court held that the tax benefit rule was not applicable. Rojas v. Commissioner, 90 T.C. at 1100. The court also noted that the nonapplication of the tax benefit rule was consistent with the intent of Congress to allow farmers currently to deduct crops costs without the necessity of matching such costs against the income which would be realized from the sale of the crops. Rojas v. Commissioner, 90 T.C. at 1108-1109.

Several judges on the court dissented in this opinion. The dissent maintained that the majority opinion placed too much reliance on the consumption of the asset as the overriding justification for granting a section 162 deduction. Rojas v. Commissioner, 90 T.C. at 1114. However, the Tax Court opinion was affirmed by the Ninth Circuit Court of Appeals. Commissioner v. Rojas, 901 F.2d 810 (9th Cir. 1990).

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If you have any questions regarding this matter, please contact Lorraine E. Gardner at (PTS) 566-3335.

DANIEL J. WILES


STEVEN J. HANKIN
Special Counsel Corporate
Field Service